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Estate Planning for "Yours, Mine, and Ours"

There's much more to estate planning than death taxes.

Under current law, those who die in 2020 with less than $11.58 million in assets will owe no federal estate tax. That number will grow with inflation each year, until 2026, when it will fall roughly in half. Congress might make the larger exemption permanent—or they might advance the date for expiration of the larger amount. In these unusual times, predictions are hard.

As fewer and fewer families need to worry about death taxes, it is important to remember that tax liabilities are just one component of a sound estate plan. Estate planners like to say that because every family is unique, there are no "cookie-cutter," one-size-fits-all solutions. The truth of that axiom is best demonstrated by looking at the unusual problems that can be presented by "blended families," those resulting from multiple marriages. High divorce rates are one source of the phenomenon, but so is growing life expectancy.

The following fictitious stories illustrate some of the estate planning problems that may crop up in these situations.

The lost inheritance. Ann had been widowed for five years when she married Jack, a divorced man with two adult children from his first marriage. Ann had three grown children of her own. She was left in very good financial shape at her husband's death, and she had done a good job of managing her money on her own. Ann's big mistake was that she agreed that she and Jack should leave all their assets to each other. Ann was certain that she would outlive Jack anyway, as he was older and in poor health.

When Ann died unexpectedly, Jack inherited everything from her. Ann's children aren't likely to get any inheritance from their parents, as Jack has big plans for taking care of his own children.

May-December marriage. Mark has remarried several times, but now he's found the one with whom he plans to

stay for the rest of his life. Megan is quite a bit younger than Mark. In fact, she's younger than Mark's children from his first marriage!

Mark's estate plan gave Megan a lifetime income interest in his assets. She had the right to live in their home and received all the income from their investments. At her death, Megan did not have the power to direct these assets to others—Mark had seen to it that his children could not be disinherited. What Mark failed to anticipate was that Megan would live longer than any of his children, so none of them received any inheritance!

An unexpected return. Tom and Sara lived the "Yours, Mine, and Ours" story. They each brought a child to their marriage, and then they added two more. They succeeded in keeping friction among the stepsiblings to normal levels and appeared to be heading toward "happily ever after."

But when Tom died, an unexpected beneficiary appeared. It turned out that Tom never had changed the beneficiary designation on his 401(k) plan, so his first wife, Molly, inherited nearly $1 million. Sara and the couple's children were shortchanged.

Solutions

The first tool to think about in a second marriage situation is a prenuptial agreement, or "prenup" for short. Although these documents have their greatest utility in the context of divorce, because they spell out in advance what each spouse may expect, a prenup can be valuable for estate planning as well. The prenup will identify the assets that each partner brings to the marriage, and it may specify which assets will remain separate property. Provision may be made for the expected eventual distribution of the property. The process of inventorying assets lays a good foundation for subsequent estate planning.

Tom's mistake was that he never "finished" the divorce from his first wife. Steps need to be taken to change beneficiaries for every life insurance policy, IRA, and retirement plan. A thorough asset review in connection with creating a prenup, before Tom and Sara married, would have revealed any oversights.

Ann's husband should have employed a Qualified Terminable Interest Property (QTIP) trust to provide for widowhood, rather than leaving her their property outright. With a QTIP trust, the children's inheritance normally can't be diverted. The surviving spouse must receive all of the trust income, paid at least annually. The trustee also may be given the power to invade trust principal in specified circumstances. But at the widow's death, the remaining trust assets pass as specified by the person who established the trust.

Mark did use a QTIP trust, but the problem was that he failed to take into account the likely survivorship of his young wife. Mark would have been well advised to purchase life insurance to create an inheritance for his children at his death. He could have employed an irrevocable life insurance trust to avoid estate taxes on the insurance, while the QTIP marital deduction eliminated estate taxes on what Megan received.

Long-term trusts

The most flexible approach to preserving an inheritance for children, whether they are minors or adults, is a trust. The trustee can take subsequent circumstances into account in sprinkling the income distributions among the beneficiaries. An irrevocable trust also provides financial protection in divorce, bankruptcy, and lawsuits. It can be a mechanism for supporting financial discipline and avoiding irresponsible spending and the waste of an inheritance.

Take the next step

Basic estate planning for blended families requires care and regular review. An estate planning attorney's supervision will be required. We will be pleased to offer our assistance as well. ☐

Choices for marital trusts

Trust type	*Estate tax exposure at spouse's death*	*All income to spouse?*	*Spouse can direct remainder?*	*Comment*
Traditional marital deduction trust	Yes	Yes	Yes	Best for larger estates, paired with a credit shelter trust
Qualified Terminable Interest Property (QTIP) trust	Elective	Yes	No	Best for multiple-marriage situations
Credit shelter trust	No	Elective	No	Appropriate by itself for smaller estates, but may be paired with traditional or QTIP trust
Qualified Domestic Trust (QDOT)	Yes	Yes	Elective	For a spouse who is not a U.S. citizen

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True story

An acquaintance of ours had four children, and so when he added stocks to his portfolio of blue-chip stocks he always bought in lots of 400. When he was in his 70s, he surprised the kids with gifts of 100 shares of one blue-chip company. He kept up the practice every Christmas after that, giving them shares of a different well-known firm every year.

In 2012, when this gentleman was 83 years old, he did something quite out of character for someone who had prospered by investing in dividend-paying firms with long track records in traditional fields. On an impulse he bought 400 shares of an internet company after its IPO.

Seven years later, when he was 90, he gave those shares to his children. His great present and pleasure that Christmas was the shocked look on their faces—they never dreamed he had even heard of the company!

How to help the younger generation start investing

The American Association of Individual Investors surveyed some of their members recently about their actions in getting their children and grandchildren interested in saving and investing. Their findings, which were not surprising, were published in the April 2020 issue of the *AAII Journal.* They found that of the respondents:

- 36% gave investing advice to children, grandchildren, or both;
- 10% opened an account for them;
- 8% gave them shares of stock;
- 8% gave cash, in amounts ranging from hundreds to tens of thousands of dollars.

The most important piece of advice that these investors had for the younger generation was to start early and save regularly. That puts time to work on the investment portfolio. They advised saving at least 10% of one's salary and preferred stocks to bonds for long-term wealth accumulation. They also recommended tax-preferred accounts, particularly Roth IRAs for those in low tax brackets.

A majority of the respondents (57%) reported helping their children, while 25% helped grandchildren and 18% assisted more remote relatives. Some 22% also reported that they had helped a nonrelative to begin an investment program.

One technique to get young people motivated to start saving is to illustrate the remarkable power of compound investing. Another is to have them create and track a small hypothetical portfolio for three or four months.

The best time for getting started on saving and investing, according to 63% of the respondents, was in high school, ages 14-18. Some 17% said early in the career, ages 23-30, while 13% identified the college years as the best age.

Who motivated the respondents to get going on their own investment programs? The largest group, at 40%, said that they were self-motivated. About a third had themselves received help from a family member early on. Many mentioned that they had seen how their own parents were not fully prepared for retirement and vowed to be different.

Tax notes

This year one may give up to $15,000 worth of property to each of as many donees as one wishes without incurring any federal gift tax. State gift taxes have been abolished in every state except Connecticut. Making such lifetime transfers, especially if done regularly for a period of years, may also reduce the impact of death taxes. Not many families have to worry about federal estate taxes this year, because they don't kick in until an estate exceeds $11.58 million. However, that exemption level could be reduced in future years, perhaps dramatically.

A particularly good candidate for gifts to the younger generation would be shares of stock with large built-in appreciation. The donor avoids paying tax on the capital gain. The tax basis of the shares is carried forward to the donees, who could be in the 0% tax bracket when they sell the shares.

Be sure to consult with your tax advisors before taking any action. ☐

Surviving spouse as trustee

When a surviving spouse is named as trustee in an estate plan, the result can be family disharmony. Two recent cases illustrate what can happen.

Power of appointment

Berkowitz and his wife executed a living trust that provided for a life income for the survivor of the two of them, with the trust remainder passing to their daughter, Alexandra, and her children. The survivor would be the trustee and would also have a general power of appointment over the property, including the power to appoint to himself or herself. The attorney who drafted the trust explained to the couple that the power of appointment would give the survivor unfettered access to the trust assets.

After the wife died, Berkowitz exercised the power in favor of himself. Alexandra was unhappy at losing her contingent interest, and she filed suit alleging that as trustee Berkowitz had a fiduciary duty to other trust beneficiaries.

There was no such duty, the California lower court ruled, either in trust law or in the trust document. The appellate court affirmed that decision. The result would have been the same had Berkowitz resigned as trustee before exercising his power. In that event the successor trustee still would have been obligated to distribute all the trust assets to him.

Trust administration

William created a two-trust estate plan. His surviving spouse, Dale, was the trustee of both trusts as well as the income beneficiary. A marital deduction trust provided its remainder to William's two daughters from an earlier marriage, and a credit shelter trust provided its remainder to Dale's grandchildren from earlier marriages. Dale had the power to make principal distributions to herself in amounts that she "shall deem necessary for the proper support, care, and maintenance" of herself.

Dale made all such trust invasions from the marital trusts, which favored her own children by leaving the credit shelter trust intact. William's daughters from his earlier marriage filed suit, alleging a breach of fiduciary duty and demanding an accounting of the trusts. They contended that all trust invasions must be "necessary," and so Dale's other resources must be taken into account to justify them.

The district court agreed with the daughters, but the appellate court reversed. Looking at the trust as a whole, the court found that a provision for a grandson explicitly was premised upon his other income sources, while the provision for Dale was not. The court concluded that William did not intend to tie Dale's hands with regard to distributions to herself, so she was free to choose which trust to invade first. ☐

Let us help you choose the best options for preserving your wealth.

Our Trust Division is staffed with friendly and knowledgable advisors to help you make the best decisions for managing your assets and transferring them accordingly when the time comes.

For more information, call (870) 793–4441.